



Michael C. Schlachter, CFA
Managing Director

January 23, 2009

Mr. Theodore Eliopoulos
Interim Chief Investment Officer
California Public Employees' Retirement System
400 P Street, Suite 3492
Sacramento, CA 95814

Re: Credit Enhancement Program Annual Review

Dear Ted,

CalPERS' Credit Enhancement Program is one of the areas where we believe that CalPERS "Does well by doing good." CalPERS is able to significantly reduce the interest rates paid by public entities that issue debt while simultaneously earning a moderate rate of return for its time and effort. To date, this program has been very successful, generating \$3.9 million of fee-based income in 2008. We believe that the Investment Committee should continue this effort.

The current "credit crisis" environment has yielded returns over the past year which have been higher than those historically realized by CalPERS and should continue to generate returns above the historical average for the foreseeable future. Several other credit enhancement participants have exited the industry, leaving more opportunities for CalPERS to choose between. In addition, the ongoing credit crisis and economic downturn has put more pressure on public entities to issue debt and to reduce their costs of such issuance by any means necessary. In simple terms, this increase in demand for CalPERS' services (issuance) coupled with a decreased supply (number of credit enhancers) results in a far greater price (fees paid to CalPERS).

We will note, however, that this activity, like securities lending, should not be considered a "free lunch". Although defaults by municipal issuers are extremely rare, they are not impossible. As Staff noted in their agenda item, 44 out of 50 states currently face budget shortfalls. In addition, Wilshire noted at the January Board offsite that recent data indicates that tax revenues paid to states should fall short in 2009 of projected outlays by an amount equal to approximately 1% of national GDP. If there was ever a time when municipal defaults became a possibility, that time is now. Although Staff has a very in-depth credit analysis program, generally viewed to be more extensive than that employed by the rating agencies, and should hopefully avoid enhancing debt issued by likely defaulters, there remains a chance that CalPERS could find itself in a position of needing to make good on the promises contained within this program.

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Before deciding to continue this program, the Board should be fully aware of this risk and should understand the potential impacts on CalPERS should an enhanced issuer default.

If you have any questions, please do not hesitate to contact me.

Sincerely,

A handwritten signature in black ink, appearing to read "Michael Schlachter", with a long horizontal flourish extending to the right.

Michael C. Schlachter, CFA